

economic trends

October 2012

Consumers and new migrants help power Alberta's economy

Alberta's consumers continue to play a key role in the province's expansion, sharply increasing their spending on goods and services. An influx of new migrants has also supported continued gains in the housing market. However, in the business sector, growth in manufacturing shipments and exports has weakened in recent months.

Global Economy

International Monetary Fund cuts forecast

For the second time since April, the IMF has lowered its forecast for the global economy, citing greater downside risks. Global output growth was revised down by 0.2 percentage points to 3.3% in 2012 and by 0.3 percentage points to 3.6% in 2013. According to the IMF, the Euro zone debt crisis and the "fiscal cliff" of looming spending cuts and tax increases in the US have the potential to derail global growth. At least part of the downgrade reflects the IMF's belief that policymakers have not done enough to address these issues.

The IMF lowered its forecast for Canadian GDP growth by 0.2 percentage points in each of 2012 and 2013 to 1.9% and 2.1%, respectively. It considers elevated levels of

Key Indicators

All indicators seasonally adjusted unless otherwise indicated.

Indicator	Latest Month	Value	Change year-over-year (y/y)
Employment (thousands)	September	2,156	1.8%
Unemployment Rate	September	4.4%	-0.9 p.p.
CPI Inflation	August	1.4%	-1.3 p.p.
Retail Sales	August	\$5.76B	+8.1%
Housing Starts (annualized)	September	33,400	+36.25%
Rigs Drilling (unadjusted)	October	236	-29.6%
Manufacturing Shipments	August	\$6.2B	+4.2%
Exports (unadjusted)	August	\$7.7B	-7.5%

Source: Statistics Canada, CAODC, CMHC. p.p.= percentage points.

household debt and potential housing price declines to be the major risks facing the Canadian economy.

A case for optimism?

The economic picture in the US improved over the last month, with several data releases suggesting the expansion may finally be taking hold. The August unemployment rate was 7.8%, falling below 8% for the first time since January 2009. Meanwhile, US retail sales grew by 1.1% in September, marking the first back-to-back months of above 1% growth in almost two years.

By far, the greatest case for optimism comes from the housing sector, which is finally showing signs of a sustained recovery. Housing starts jumped 15% in September, to the highest level since July 2008.

Despite some positive signs, the US economy still faces some major challenges. Weakness in labour and housing markets persists, and the prospects for recovery are clouded by uncertainty surrounding the fiscal cliff.

Business Sector

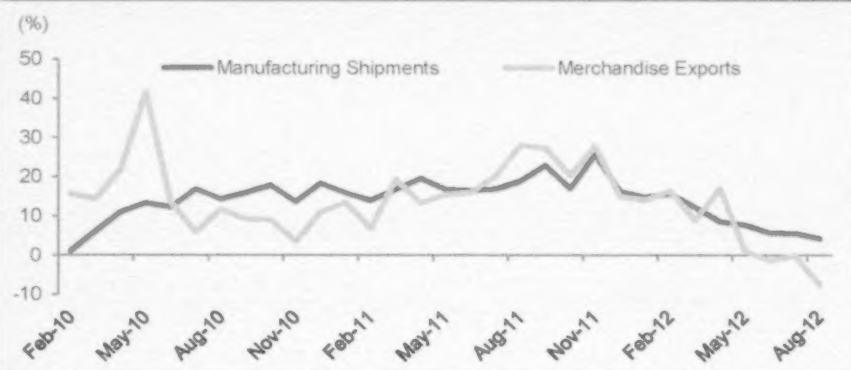
Weaker readings for exports and manufacturing shipment growth

Alberta's business sector has entered the second half of the year with softer growth readings in two key output indicators: manufacturing sales and exports.

In the manufacturing sector, sales growth has decelerated in every month since February (Chart 1), mainly due to declines in chemical and petroleum & coal products. Despite the moderation, manufacturing shipments are up a strong 9.2% in the first eight months of 2012 over the same time last year.

On the trade front, Alberta merchandise exports fell below last year's levels for the third straight month in August. Energy products, which account for more than 70% of total exports, fell by the largest amount in almost three years (-9.1% year-over-year). Lower energy prices and a pullback in volumes of

Chart 1: Growth in Alberta Exports and Manufacturing Shipments (y/y)



Source: Statistics Canada

natural gas and petrochemical products have contributed to the recent slowdown in energy product exports. Nevertheless, exports are still up by 5.6% on a year-to-date basis.

Construction activity trending higher

Spending on construction has started to ramp up. In the third quarter of 2012, real investment in non-residential building construction posted its fourth straight quarterly increase and the highest year-over-year gain in three years (Chart 2). Institutional and government construction spending, which has long been a drag on overall construction activity, recorded its first increase in 2.5 years. However, most of the construction gains continue to come from the residential sector. Housing starts are up 38.9% in the first three quarters of this year, spurred by strong migration and labour conditions.

Moving forward, data on building permits suggest that strong construction activity will continue. Through the first eight months of the year, residential permits are up 19.7%, while non-residential permits have risen 6.0%.

Household Sector

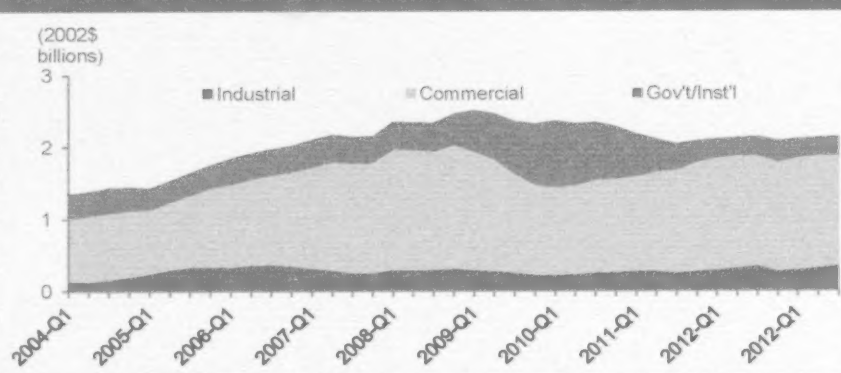
Alberta leading country in year-to-date job growth

Another 2,100 jobs were added in September, marking the seventh month of job gains this year. The year-over-year pace of employment growth has been moderating in recent months, from 4.1% in May to 1.8% in September. The slowing growth mainly reflects the acceleration of employment gains in mid-to-late 2011. This is making it more difficult to sustain elevated year-over-year growth moving through the second half of 2012 (Chart 3). Despite the recent moderation, Alberta's year-to-date job growth remains the highest in the country at 2.9%, fueled by gains in full-time positions and the private sector. Most of the new jobs have been in the goods sector, led by the oil and gas, utilities, and agriculture industries. Alberta's unemployment rate was the lowest in the country for the sixth straight month, remaining at 4.4% in September, a four-year low.

Inflation pressures remain subdued

Alberta is not seeing much pressure on its inflation rate. After starting the year with a January reading of 2.9%, the CPI inflation rate has fallen to the 0.4%-1.4% range since

Chart 2: Alberta Spending on Non-Residential Building Construction



Source: Statistics Canada.

April due to falling energy prices and only small increases in housing costs. August's reading was 1.4%, well below the 10-year average rate of 2.6%. Year-to-date, Alberta holds the lowest inflation rate in the country at 1.4%.

Consumer spending remains robust

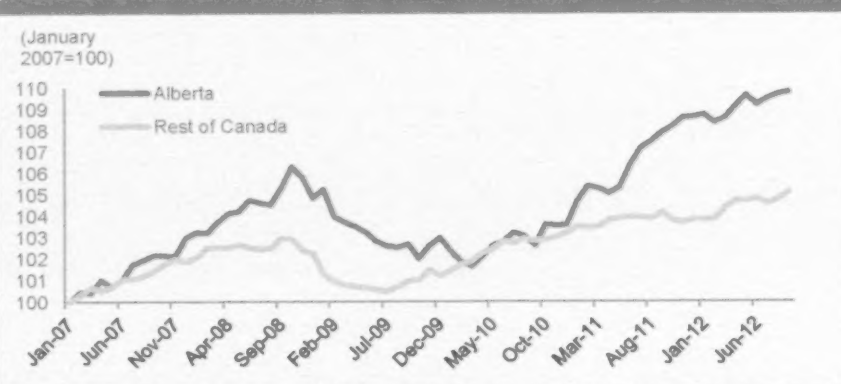
Alberta's strong labour market and fast growing population continue to spur consumer spending. August retail sales rose 8.1% y/y to a new record, bolstered again by strong vehicle sales (+20.1%). In the first eight months of the year, retail sales were up 8.9%, the highest rate in the country and nearly triple the national average. This, combined with low consumer price inflation, suggests that consumers are playing a key role in Alberta's current economic expansion.

Average work week hits highest level on record

In August, Albertans paid by the hour worked an average of 33.0 hours per week according to Statistics Canada's Survey of Employment, Payroll and Hours. This is the highest level since the data began in 1991. Some of the recent increase likely reflects compositional effects, such as the strong growth in full-time employment and in industries with longer average hours worked (e.g., oil and gas).

The combination of longer hours worked and wage gains has translated into a 3.1% improvement in average weekly earnings (AWE) so far this year. This is below last year's growth in AWE but well above the rate of inflation and the national average increase (2.3%).

Chart 3: Employment in Alberta and Rest of Canada (Index)



Source: Statistics Canada

What's behind the recent slowdown in China?

The Chinese growth miracle has been one of the most captivating stories of the new century. For energy producers like Alberta, China is incredibly important due to its large share of global energy consumption and its impact on commodity prices.

China's meteoric growth may be coming back to Earth. This InFocus examines the factors driving growth to determine whether the recent slowdown is likely to persist.

China's economic growth at three-year low

Since 2010, economic growth in China has trended steadily downward, from a high of 12.1% year-over-year (y/y) in the first quarter of 2010 to just 7.4% y/y in the third quarter of 2012. Other indicators also suggest a slowdown, as growth in both retail sales and industrial output has moderated significantly since 2010 (Chart 1). Whether or not slower growth persists depends on the extent to which the underlying factors driving the slowdown are structural versus cyclical.

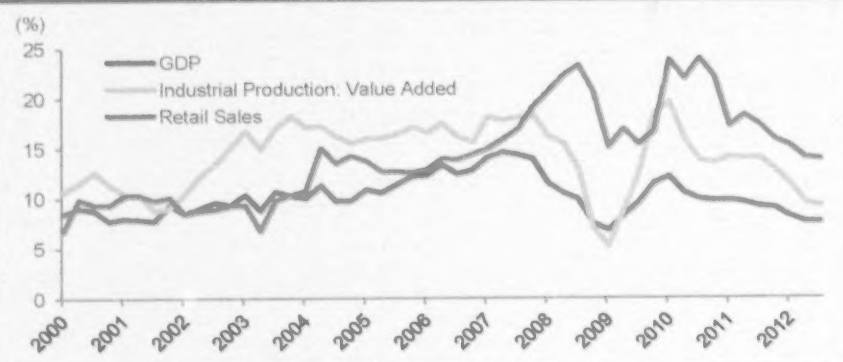
Cyclical factors

Cyclical changes in output are caused by short-run fluctuations in demand. Both a weak recovery globally and tight policies domestically have weighed on demand in China, as described below.

Global Demand

Global headwinds have been a major factor holding back growth in China. Exports make

Chart 1: Economic Indicators for China (y/y growth)



Source: Haver Analytics

up more than a quarter of Chinese GDP, and historically have been a major driver of economic growth. Between 2002 and 2011, China's exports averaged 20% annual growth. However, to date in 2012, exports are up by just 4.8%. Demand for Chinese exports has been hit hard, as the European Union, China's largest trading partner, is in recession. Demand also remains weak in China's second largest trading partner, the US. As advanced economies start to operate closer to their productive capacity, the contribution of exports to China's GDP growth is likely to rise.

Policy tightening

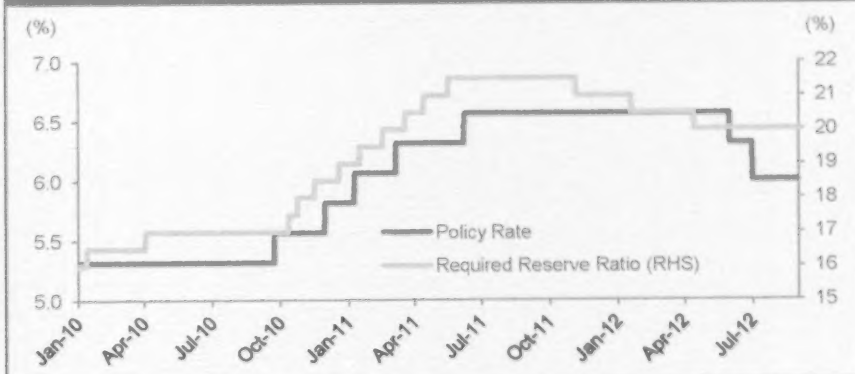
Chinese policymakers can do little to stimulate global demand, but they do have considerable control over domestic demand. Chinese

demand has been held back by efforts to curb inflation and prevent overheating in the economy.

From mid-2010 to mid-2011, the People's Bank of China (PBoC) aggressively tightened monetary policy (Chart 2). The key lending rate was increased incrementally from 5.3% in September 2010 to 6.6% in July 2011. Starting in June 2010, the Yuan was allowed to float and subsequently appreciated by 8.5%. In addition, between May 2010 and June 2011 the PBoC raised the required reserve ratio from 16.5% to 21.5% to encourage financial stability and limit the supply of credit.

These policies were effective at reducing inflation, which fell from a peak of 6.7% y/y in July 2011 to just 1.8% in September 2012. Any of these measures in isolation could be expected to negatively affect growth. Together they provided a major drag on aggregate demand. Nominal GDP growth nearly halved from 18.1% y/y in the second quarter of 2010, to just 9.3% in the third quarter of 2012. More recently, the stance of monetary policy has shifted from contractionary to expansionary. Between May and July of this year the PBoC reduced its key lending rate by a total of 50 basis points, and since December 2011 it lowered the required reserve ratio three times by a total of 150 basis points. While this will provide a boost to the Chinese economy, it is unclear if it will overcome weak global demand.

Chart 2: Monetary Policy Indicators for China



Source: The People's Bank of China/Haver Analytics

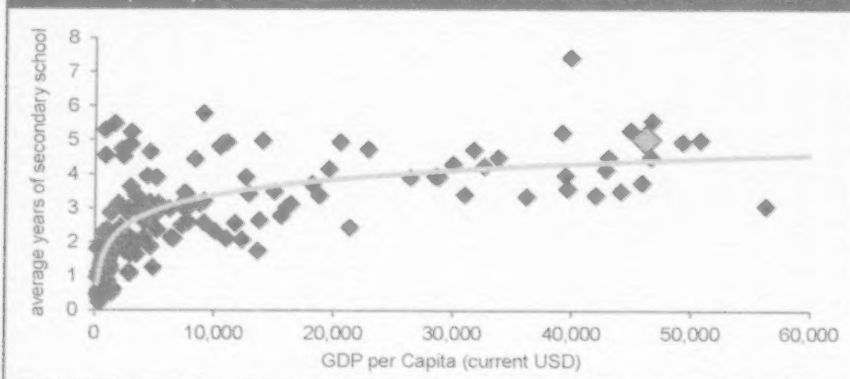
Structural Factors

The structure of the Chinese economy has changed dramatically in the last 20 years. In 1990, China accounted for just 3.9% of world production despite its 22% share of the global population. For the next 20 years, China's economy would grow by an average of 10% a year, increasing China's share of global production to 13.5%. This awesome growth was achieved by channeling resources into education, moving workers into cities where they are more productive, and investing heavily in infrastructure and public works projects.

China has made huge strides towards improving the education level of the average person. From 1990 to 2010 the adult literacy rate increased from 77.8% to 94.2%, secondary school enrollment went from 40% to 81%, and tertiary education from 3% to 40%. On average, countries with more educated workers offer higher wages and a higher standard of living (Chart 3).

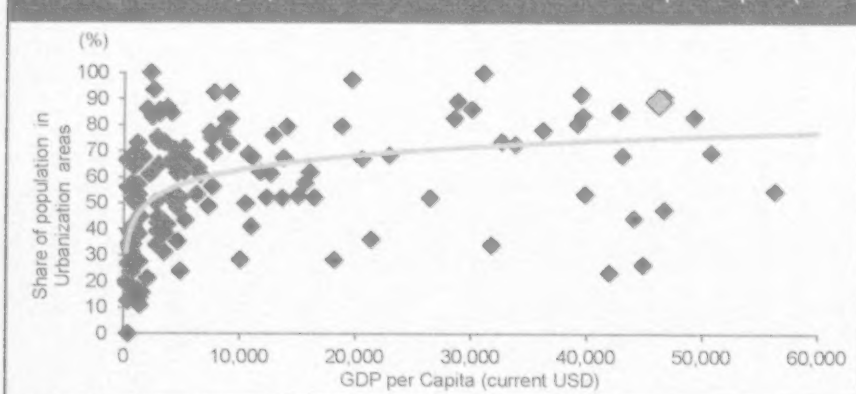
Urbanization has also promoted Chinese economic growth. The percentage of China's population living in urban areas nearly doubled from 26% in 1990 to 51% in 2011 (Chart 4). Urban centers are more productive than rural areas, partly because there is greater knowledge transfer between people and businesses. They also have greater access to financial markets and public goods (schools, hospitals, etc.).

Chart 3: Average years of secondary school and GDP per capita (2011)



Source: World Bank, Barro-Lee (2011). China is red marker, Canada is green, other countries are in blue.

Chart 4: Share of population in urban areas and GDP per capita (2011)



Source: World Bank. Markers represent countries. China is red, Canada is green, other countries are in blue.

Finally, investment in China has proceeded at a breathtaking pace, making up 46% of GDP in 2011. This has been sustained in large part by a high household savings rate (39% in 2008). As the returns on additional investment decline, spending in the economy is likely to shift more towards consumption.

Are the good times over?

The reality is that China will not be able to sustain 10% annual growth over the long term. Urbanization and investment in human and physical capital are all subject to diminishing marginal returns. As living standards converge towards those in advanced countries, so too will its growth rate. Complete convergence, however, is a long way off. China is still a relatively poor country. GDP per capita would have to double just to be on par with Mexico, let alone the more advanced economies. Charts 3 and 4 show that advanced economies tend to have higher levels of urbanization and education, and that there are still more gains to be had from both.

There is also a concern that since investment has been a strong growth driver for China, the sheer scale of investment could cause an asset price bubble. If the bubble bursts, the fall in asset prices could cause a major slowdown as households and businesses cut back on consumption and investment to rebuild their balance sheets.

A small bump in a long road

China is a country with tremendous natural and human resources that for most of its history have gone underutilized. The tremendous economic growth over the last 20 years is a consequence of better utilizing these resources. With so many efficiencies still to gain, China is capable of high growth for many years to come. Two years of gradually slowing growth is hardly enough data to call the problem structural, especially when cyclical factors like the broader global slowdown and substantial policy tightening fit the data so much better.

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